The Cramdown on Secured Creditors: An Impetus Toward Settlement*

by
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Chapter 11 of the Bankruptcy Code sets forth the procedures for the confirmation of a reorganization plan. Section 1129(a) includes the criteria for the most frequently used method of confirmation—that of settlement by the debtor, creditors, and equity holders. Such settlement often involves gaining unanimous consent of all of the parties. However, in the absence of unanimity within any class, the best interest of creditors test under section 1129(a)(7) protects dissenting members of a consenting class by setting forth standards that a plan must meet in regard to their claims if the plan is to be confirmed.

Section 1129(b) sets forth an alternative method of confirmation called the "cramdown," which is often written about and discussed but which has occurred in relatively few cases since the Code has been in effect. The cramdown option permits the confirmation of a plan notwithstanding the failure of one or more classes of impaired claims or interests to accept the plan under section 1129(a)(8). With the exception of section 1129(a)(8), all of the other conditions specified in section 1129(a) must be met for the confirmation of the cramdown of a plan under section 1129(b). The cramdown is one of the new provisions included in the Code to facilitate the confirmation of a plan in the face of opposition by one or more classes. Perhaps more importantly, most commentators view the inclusion of the cramdown provisions as favoring settlement, since the complexity and risks involved in a cramdown should encourage compromise and bargaining among the debtor, creditors, and equity holders.[1] For instance, Richard F. Broude claims:

> the risks of failure to reach settlement are so great, and the possible negative impact of the imposition of the cramdown

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[1] Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 Bus. Law. 441 (1984); Coogan, *Confirmation of a Plan Under the Bankruptcy Code*, 32 Case W. Res. L. Rev. 301 (1982); Klee *All You Ever Wanted to Know About Cram Down Under the Bankruptcy Code*, 53 Am. Bankr. L.J. 133 (1979); Pachulski, *The Cram Down and Valuation Under Chapter 11 of the Bankruptcy Code*, 58 N.C.L. Rev. 925 (1980).

> powers so significant, that the cramdown power is used more as a threat than as a club actually employed in confirming a plan of reorganization. Further, in an arena where timing is often more important than the ideal result, the delay caused by invocation of the cramdown power is likely to result in harm to all.[2]

This article will discuss the cramdown on secured creditors under sections 1129(b)(1) and (2)(A). However, an understanding of the cramdown on secured creditors is at times inextricably linked to an understanding of the cramdown on unsecured creditors and equity holders. At those times, especially in discussion of the case law history and legislative background of the cramdown, there will be frequent reference to cases that involve the cramdown on unsecured creditors.

The first part of this article will be devoted to discussion of the history of the cramdown, tracing the development of the pre-Code case law and pointing out issues of particular interest to the cramdown on secured creditors under the Code. Next, the statutory development preceding the Code and the legislative debate and history of the Code itself will be considered.

In part II consideration is given to the cramdown provisions in sections 1129(b)(1) and (2)(A) and some of the related provisions, such as sections 1124, 1126(f), and 1111(b). Included is discussion of some of the confusion inherent in the cramdown provisions themselves and other ambiguities caused by the interaction of the cramdown provisions with these other provisions, some of which were remedied by the 1984 Amendments to the Code. Cramdown is examined from various perspectives—from that of the drafters, to suggest what the provisions were envisioned to do; from that of the debtor and the secured creditors, to ascertain what alternatives they have and what decisions they must make in respect to the cramdown; and from that of the practitioner who wants to learn what forms have to be filed, after certain decisions have been made.

Part III will consider the valuation problems that are involved in a cramdown on secured creditors. The many risks involved in valuation demonstrate why it is most advantageous for the debtor and secured creditors to negotiate and try their best to reach a settlement under section 1129(a) rather than to seek a cramdown under section 1129(b).

The Addendum to this article includes a fact situation and related problems. The problems are meant to elucidate the valuation risks that arise in a cramdown. They also offer an opportunity to see how the standards contained in section 1129(b)(2)(A) function in practice, as well as demonstrate

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[2]Broude, *supra* note 1, at 441.

that the cramdown process does not involve the application of clear-cut, scientific principles. Finally, the problems offer another perspective as to why the cramdown provisions loom as a threat and lead parties to reach settlement.

PART I.

A. Pre-Code Case Law

Section 1129(b) of the Code should not be read in isolation. Rather, it is the culmination of decades of gradually evolving conceptions about the relationship between creditors and debtors, the best way for creditors to protect themselves in the face of debtor insolvency, and the criteria required for confirming a reorganization plan (or historically, its equivalent). Through an analysis of the major cases decided over the past three-quarters of a century, most of which concern unsecured creditors, but which are important for learning about the treatment of secured creditors, an attempt is made to show how the cramdown principles evolved. The second half of part I discusses the reactions that the drafters of the Code had toward this case law, as demonstrated by the provisions they included in section 1129.

Section 1129(b)(1) requires that to be confirmed, a plan must be "fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." Section 1129(b)(2)(A) goes on to specify certain standards to be used for ascertaining whether a given plan is "fair and equitable" with respect to a class of secured claims. This phrase, "fair and equitable," has a long and richly litigated history closely tied to that of the "fixed principle," and the "absolute priority rule." Yet, confusion exists about the origination of the "fair and equitable" phrase:

> It is not easy to trace the history of the 'fair and equitable' phrase. The Court [in *Case v. Los Angeles Lumber Products Co.*][3] cites railroad receivership cases as authority for the meaning of the phrase. Although none of the cited cases used the exact phrase, the Court concluded that 'the phrase became a term of art used to indicate that a plan of reorganization fulfilled the necessary standards of fairness.'[4]

It is helpful to trace the development of the principles that led to the "fair and equitable" standards. Many commentators point to the Supreme Court's decision in *Northern Pacific Railway Company v. Boyd*[5] as heralding the arrival of the "fixed principle" for judging the adequacy of reorganization

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[3]308 U.S. 106 (1939).

[4]*Coogan*, *supra* note 1, n.57 at 313, citing *id.* at 118.

[5]228 U.S. 482 (1913).

plans.[6] Vern Countryman, however, has shown that the "fixed principle" of *Boyd* was foreshadowed in two earlier Supreme Court cases, *Chicago, Rock Island & Pacific Railroad Co. v. Howard*[7] and *Louisville Trust Co. v. Louisville, New Albany & Chicago Ry. Co.*[8] (the *Monon* case).[9] In *Howard*:

> An agreement was made between the mortgage bondholders and the stockholders that the railroad properties should be sold for $5,500,000 of which 16% was to be paid to the stockholders and the balance to the bondholders, with no provision for the unsecured holders of the [rail]road's guarantees on the municipal bonds.[10]

The Court held that such an arrangement was void because the stockholders had been paid their 16% before the unsecured creditors had been paid anything. In effect the Court resorted to the old trust fund theory, which holds that in liquidation the order of priority puts the unsecured creditors ahead of the stockholders, but behind the junior and senior secured creditors. Under this theory, when the secured creditors agreed to take 84%, they discharged the rest of their claims, so that the remaining 16% belonged to the corporation and should have been used to pay off the unsecured creditors and not the shareholders. If the secured creditors had taken 100%, the unsecured creditors would have had no valid claim to any of the fund, since under the Court's theory, unless the secured creditors agree otherwise, they must get paid in full before any other class of creditors or shareholders shares in the fund.[11] In *Howard*, the Court thus sets a foundation for both the "fixed principle" and the "absolute priority rule."

The *Monon* case involved another scenario in which the secured bondholders and shareholders entered into an advance agreement to the detriment of the unsecured creditors whom they ignored. In this case the Court articulated the beginnings of what came to be called the "fixed principle": "the stockholders' interest in the property is subordinate to the rights of creditors. [A]ny arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation."[12] The decision implied that priority must be absolute, unless the secured and unsecured creditors agree otherwise. In the absence of such an

[6]*See* V. Countryman, Corporate Reorganization Seminar Manuscript at 19ff (Spring 1984) (unpublished manuscript); 5 COLLIER ON BANKRUPTCY ¶1129.03[2], (15th ed. 1985).

[7]74 U.S. (7 Wall.) 392 (1869).

[8]174 U.S. 674 (1899).

[9]Countryman, *supra* note 6, at 21.

[10]*Id.* at 19.

[11]74 U.S. at 409–410, 414.

[12]174 U.S. at 684.

agreement, a foreclosure cannot preserve anything for shareholders until secured creditors, and then unsecured creditors, are paid in full.

It was in *Boyd* that the Court named the "fixed principle" and expanded the Court's supervisory function in determining whether any given agreement complied with the "fixed principle." Here again, as in *Howard* and *Monon*, the plan put forward allowed the secured creditors and shareholders to share in payments before the unsecured creditors had received anything. The Court held that the unsecured creditors must be paid before shareholders: "For, if purposely or unintentionally a single creditor was not paid, or provided for in the reorganization, he could assert his superior rights against the subordinate interests of the old stockholders in the property transferred to the new company."[13]

Although the Court ruled that unsecured creditors must be paid off in full before the shareholders may receive a cent, it did not hold that they had to be paid off with one lump cash payment as part of a reorganization plan. The Court claimed that paying off the unsecured creditors first: "does not. . . require the impossible and make it necessary to pay an unsecured creditor in cash as a condition of shareholders retaining an interest in the reorganized company. His interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock."[14] This principle that a plan need not require the impossible has been carried over into the Code in section 1129(a) settlements and section 1129(b) cramdowns and is closely linked to the section 1129 (a)(11) requirement that a plan must be feasible. Under section 1129(b)(2)(A) dissenting classes of secured creditors must be paid off with either a cash stream, secured debt securities, or the "indubitable equivalent" although Countryman contends that dissenting classes of secured creditors also may be compelled to accept equity securities under the "indubitable equivalent" standard of section 1129(b)(2)(A) (iii). If Countryman is correct, then in those situations where classes of secured creditors are paid with stock, the court must value both the securities and the going enterprise if any other class dissents in respect to the plan.

Although the "fixed principle" was more or less accepted as the law in 1913, consensus did not exist as to whether the "fixed principle" mandated application of the "absolute priority rule"[15] (a term originated in 1928 by James Bonbright and Milton Bergerman in their article, *Two Rival Theories of Priority Rights of Security Holders in Corporate Reorganizations*[16]) or the "relative priority rule."[17] Although the "absolute priority" rule was accepted

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[13]228 U.S. at 504.
[14]*Id.* at 508.
[15]5 COLLIER ON BANKRUPTCY, *supra* note 6, ¶1129.03[2], n.10.
[16]28 COLUM. L. REV. 127 (1928).
[17]Countryman, *supra* note 6, at 43–44.

by many courts, some courts utilized the alternative "relative priority" rule.[18]

In *Case* and again two years later in *Consolidated Rock Products Co. v. DuBois*,[19] the Supreme Court upheld the rule of "absolute priority." The rule as interpreted in earlier cases had been that in the absence of an agreement between the classes of secured creditors and classes of unsecured creditors, all senior secured creditors had to be paid off in full before junior secured creditors could be paid anything, junior secured creditors before unsecured creditors, and unsecured creditors before shareholders. In *Case*, in contrast the Court interpreted the "absolute priority" rule more strictly as meaning just what it says—as one commentator puts it, "Approval of the statutory two-thirds of the class [in amount and number] did not excuse the judge from making a fair and equitable finding."[20] Another commentator agrees:

> This was an absolute rule and, if strictly adhered to by a court considering a plan of reorganization, would have forbidden creditors and other parties in interest in a [C]hapter X case from making accommodations among themselves in order to be able to confirm a plan in timely fashion and with fewer legal and other expenses that might otherwise be incurred.[21]

This strict vision of the "absolute priority" principle decided under both section 77B (the predecessor provision of Chapter X) and also under Chapter X continues in the cramdown provisions of section 1129(b) relating to the "fair and equitable" standards, but only as applied to the dissenting class or classes.

In earlier cases the courts had used the "fixed principle" and "absolute priority" rule to set the foundation for what came to be known in *Case* as the "fair and equitable" doctrine. In *Case* and *DuBois*, the Court then tried to define better what these "fair and equitable" requirements meant. Much as the *Boyd* court linked the "fixed principle" to a feasibility requirement in respect to the issuing of securities by a reorganizing debtor, the *DuBois* court linked the "fair and equitable" standards to a feasibility requirement in respect to an enterprise valuation of the reorganizing debtor. The *DuBois* court set out a procedure for valuing the enterprise which involved capitalizing prospective earnings. Once arriving at this figure, the court then decided

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[18]*See* Bonbright and Bergerman, *supra* note 16; *id.*; Countryman, at 44–46. Bonbright and Bergerman argue in favor of the "relative priority" rule.

[19]312 U.S. 510 (1941).

[20]Coogan, *supra* note 1, at 312; *See* 5. COLLIER ON BANKRUPTCY, *supra note* 6, ¶1129.03[2].

[21]Broude, *supra* note 1, at 442.

whether it satisfied the "fair and equitable" and feasibility requirements.[22] To put it in the Court's own words:

> Findings as to the earning capacity of an enterprise are essential to a determination of the feasibility as well as the fairness of a plan of reorganization. Whether or not the earnings may reasonably be expected to meet the interest and dividend requirements of the new securities is a *sine qua non* to a determination of the integrity and practicability of the new capital structure. It is also essential for satisfaction of the absolute priority rule of *Case*. . .[23]

Peter Coogan has described the Court's valuation process in simpler terms, as a two-step procedure: After deciding on an estimated probable yearly earnings value, this "estimate was then multiplied by a suitable times earnings multiple to produce an entity valuation."[24] Part III contains a discussion of this valuation procedure in greater detail, but it should appear evident by now that such a procedure is far from scientifically exact. Though Coogan believes that this *DuBois* evaluation process involves a "guess compounded by an estimate,"[25] and some "crystal ball gazing,"[26] he still believes that abstractly it "may have been and still is the best method available."[27]

Two years after *DuBois*, in *Ecker v. Great Western Railroad Co.*,[28] the Supreme Court approved an alternative method of enterprise valuation that had been used by the Interstate Commerce Commission in railroad reorganizations.[29] In *Ecker* the Court again decided on an estimated probable yearly earnings value but did not capitalize it, *i.e.*, did not multiply it by a times earning multiple. Rather, it "directly compared the available estimated earnings against the interest or dividend requirements of the securities to be issued."[30] Again, it is a matter of debate whether in a cramdown under section 1129(b)(2)(A), a class of secured creditors may be compelled to accept equity securities. *Ecker* is mentioned here to demonstrate that there are alternative procedures for ascertaining the enterprise value of a corporation under section 1129(b) for purposes of determining the feasibility of a plan.

It is also important to notice that in both *DuBois* and *Ecker*, the enter-

[22]5 COLLIER ON BANKRUPTCY, *supra* note 6, ¶1129.03[2].
[23]312 U.S. at 525.
[24]Coogan, *supra* note 1, at 313.
[25]*Id.*, at 313, n.62 citing Coogan's remark in H.R. REP. No. 595, 95th Cong., 1st Sess., 222 (1977).
[26]Coogan, *supra* note 1, at 313.
[27]*Id.*
[28]318 U.S. 448 (1943).
[29]Coogan, *supra* note 1, at 354.
[30]*Id.*

prise was valued on the basis of a going concern rather than a liquidation value. The going concern approach:

> was justified by the fact that the very purpose of a reorganization proceeding is to avoid a forced sale of assets and to preserve the going concern value of the business by continuing its operations. It is incongruous to value a business that is being reorganized on the basis of the price its assets could fetch on a piecemeal liquidation when the entire theory of the reorganization is that the debtor is being preserved as a going concern.[31]

This going concern approach continues in the Code, both as to enterprise valuation and the valuation of secured creditors' collateral under section 1129(b)(2)(A).

Another issue raised by *DuBois* and *Ecker* is whether the securities to be issued as part of a reorganization plan must have a par value or an actual market value equal to the value of a claim. "Under neither test, was there any pretense that the then market value of the new securities would equal the amount of the old claim replaced."[32] Other cases, however, have held to the contrary: "Occasional commentators and even less occasional decisions suggested that full satisfaction under the absolute priority rule should require payment in immediate cash equivalents, not merely in securities having a face amount which equals the cash claim."[33] *DuBois* and *Ecker*, however, support: "The prevailing view [which] seems to have been that the 'full satisfaction' was given if the surrendering senior security holders 'receive, for their total claim, a par amount of the claims for which they are exchanged.' "[34] Notice that the stricter view, requiring immediate cash equivalents, might well make it difficult to confirm some cramdown plans by making the plans infeasible. Under section 1129(b)(2)(A), this debate about the proper value of securities will only occur if Countryman's view is accepted and classes of secured creditors may be compelled to accept equity securities as the "indubitable equivalent."

A final issue in pre-Code case law that affects the cramdown and deserves mention is the relationship between a secured creditor's right to protection of his collateral (and thus his debt) and a debtor's right to protection from his creditors when he files for reorganization. The major pre-Code

[31]Pachulski, *supra* note 1, at 939.

[32]Coogan, *supra* note 1, at 354.

[33]V. Brudney & M. Chirelstein, Cases and Materials on Corporate Finance at 136 (2d ed. 1979).

[34]*Id.* at 137, citing *Missouri Pacific R.R. Reorganization*, 290 I.C.C. 477, 555 (1954), plan approved 129 F. Supp. 392 (E.D. Mo. 1955), *aff'd* 225 F.2d 761 (8th Cir. 1955), *cert. denied*, 350 U.S. 959 (1956).

case on point is *In re Prudence*.[35] In that case, when the value of the collateral became substantially less than the value of the debt it secured, the secured creditor sought to vacate the injunction against lien enforcement. The trustee responded that foreclosure would affect the prospects of the proposed reorganization plan. The court responded:

> Even if that were so, the enforcement of a secured creditor's rights may not be unreasonably and indefinitely postponed. Guaranty Trust Co. of New York v. Henwood, 867 (F.2d) 347 (C.C.A.8). Moreover, it is not adequately shown that the withdrawal of the collateral will materially affect the prospects, if any, of a successful plan. In granting the appellant [secured creditor] the relief sought, nothing is taken out of the estate in which other creditors have an interest and their attitude toward the plan would be unaffected thereby.[36]

This case involves adequate protection issues similar to those that arise under sections 361 and 362(d). The importance of *Prudence* for our needs is the issues it raises about: (1) the relationship between valuations for the purpose of determining adequate protection under sections 361 and 362 and valuations for the purpose of determining "fair and equitable" treatment under section 1129(b)(2)(A); and (2) the relationship between the "indubitable equivalent" clause in section 361(3) and the same clause in section 1129(b)(2)(A)(iii).

B. Statutory Development and Legislative History

In 1938 in the Chandler Act, Congress added Chapters X, XI, and XII to the Bankruptcy Act. Chapter X superseded old section 77B of the Act. As mentioned earlier Chapter X:

> was interpreted, although perhaps not so designed, as precluding settlement by the creditors and equity holders involved in the case. This resulted from the judicial gloss imposed by the Supreme Court on the Chapter X requirement that a plan of reorganization, to be confirmed, had to be fair and equitable.[37]

This interpretation was given to an early form of the cramdown in section 216(7) of Chapter X, which permitted confirmation of a plan of reorganization notwithstanding the opposition of a class of creditors, so long as the

[35] 90 F.2d 587 (2d Cir. 1937), discussed in 5 Collier on Bankruptcy, *supra* note 6, ¶1129.03[2].
[36] 5 Collier on Bankruptcy, *supra* note 6, ¶1129.03[2], citing 90 F.2d at 589.
[37] Broude, *supra* note 1, at 441.

dissenting classes were given certain adequate protection for the realization by them of the value of their claims against the property dealt with by the plan.[38] These forms of protection are the predecessors of what are now provided in the "fair and equitable" criteria of section 1129(b)(2)(A). Following is a list of these earlier forms of protection in section 216(7), with references to the Code provisions by which they were superseded:

(a) by the transfer or sale, or by the retention by the debtor, of such property subject to such claims. [superseded by section 1129(b)(2)(A)(i)(I)];

(b) by a sale of such property free of such claims, at not less than a fair upset price, and the transfer to such claims to the proceeds of such sale. [superseded by section 1129(b)(2)(A)(ii)];

(c) by appraisal and payment in cash of the value of such claims. [superseded by section 1129(b)(2)(A)(i)(II) which allows deferred cash payments].

(d) by such method as will, under and consistent with the circumstances of the particular case, equitably and fairly provide such protection. [superseded by section 1129(b)(2)(A)(iii)].

In comparison with Chapter X, Chapter XI contained no cramdown procedure and in 1952 its "fair and equitable" standard was deleted.[39] The aim of Chapter XI was to encourage the parties to reach a settlement. Except for arguments by analogy, Chapter XI is outside the scope of a discussion of secured creditors' rights, since it was used solely for reorganizing unsecured debt.

In the mid-1970's Congress began to debate and redraft the bankruptcy laws. The result was the Bankruptcy Code of 1979. Much of the Congressional debate revolved around the "fair and equitable" standards which had been cast in the form of the "absolute priority rule": "Early in the process, most of the knowledgeable commentators on bankruptcy concluded that, if not abandoned completely, the absolute priority rule should be modified in major respects. The importance of deal-making in the reorganization process was recognized."[40] "The result of this common-sense approach" in the Code is that the confirmation standards contained in section 1129(a) abandon the "fair and equitable" requirements[41] and allow for consensual settlement to

[38] 5 COLLIER ON BANKRUPTCY, *supra* note 6, ¶1129.03[2].
[39] Broude, *supra* note 1, at 442–43.
[40] *Id.* at 443.
[41] *Id.*

achieve a plan, either through unanimity, or if that is not possible, through protection of the dissenting members within a class under section 1129(a)(7). Section 1129(b), however, builds on the evolving "fair and equitable" principles in cases such as *Howard*, *Monon*, *Boyd*, *Case*, and *DuBois* in that it retains a "fair and equitable" doctrine which is independent of the parties' settlement. There is one important difference, however, for as the Comment in the *Collier Pamphlet Edition* states:

> The 'fair and equitable' rule applies only with respect to a dissenting class, thus representing a marked difference from the application of the rule in Chapter X cases under the Act. . . [in which] a plan was not fair and equitable unless each class in descending order first received full compensation for its claims or interests.[42]

Section 1129(b) is thus a modified carryover of the "absolute priority" rule. Though impossible under Chapter X of the Act, under the Code:

> senior accepting creditors may give up value to junior classes provided no dissenting intervening class receives less than the full amount of its claims. If no such dissenting intervening class exists, and the only dissent is from a class junior to the class which has given up value then the plan may still be fair and equitable with respect to the dissenting class provided no senior class has received more than 100 percent of its claims.[43]

In respect to the "absolute priority" rule, section 1129(a) harks back to Chapter XI and section 1129(b) to Chapter X.

What was Congress attempting to do with section 1129(b)? The House Report states, "This subsection contains the so-called cramdown. It requires simply that the plan meet certain standards of fairness to dissenting creditors or equity security holders."[44] In respect to secured creditors, though the "absolute priority" principle is applicable, the "treatment of classes of secured creditors is slightly different because they do not fall in the priority ladder."[45] This statement deserves an explanation. First of all, secured creditors are classified according to the collateral that secures their debt. Next, within any group of secured creditors who hold security interests in the same piece of collateral, further classification is usually done

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[42]*Comment* to section 1129, in COLLIER PAMPHLET EDITION, PART 3, THE BANKR. CODE (1981). *See* 124 CONG. REC. H. 11,104 (Sept. 28, 1978); S. 17,420 (Oct. 6, 1978).

[43]*Id.*; *See* H.R. REP., *supra* note 25, at 413, which adds that if a dissenting, impaired class is "paid less than in full, then no class junior may receive anything under the plan."

[44]H.R. REP., *supra* note 25, at 413.

[45]*Id.*

according to the rank of the security interests. "Secured creditors who hold liens on different items of property, or who hold liens of a different rank on the same property, should be separately classified."[46] Therefore, in most instances each secured creditor will end up in a class by himself.[47] Exceptions do occur, however, because when two or more secured creditors hold liens of equal rank on the same property of the estate, they should be included in the same class. Examples of this include:

> (1) Claims of holders of equipment trust certificates issued by a debtor and secured by a lien on equipment in favor of a trustee acting on behalf of the certificate holders.
>
> (2) Secured mortgage bonds issued under an indenture pursuant to the terms of which the indenture trustee hold a lien on property of the debtor to secure the bonds.[48]

This different character of secured claims partially accounts for the different treatment that they receive under section 1129(b)(2)(A). The main reason for the different treatment, however, is not so much that there may be fewer, smaller classes of secured creditors, but that all secured creditors, with regard to their collateral, come ahead of unsecured creditors.

This pre-Code case law and legislative history of the issues related to the cramdown on secured creditors sets the background for an analysis of the provisions for the cramdown on secured creditors, which are discussed in part II.

PART II.

A. The Code Provisions for the Cramdown on Secured Creditors

> (b)(1) Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

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[46]Pachulski, *supra* note 1, at 929.

[47]5 Collier on Bankruptcy, *supra* note 6, ¶1129.03[4][b]; 6 Collier Bankr. Practice Guide, ¶91.03 (1985).

[48]5 Collier on Bankruptcy, *supra* note 6, ¶1129.03[4][b].

(2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

(A) With respect to a class of secured claims, the plan provides—

(i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

(ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims.

B. Section 1129(b)(1)

This section includes the alternative confirmation procedure known as the cramdown, by which "a plan may be confirmed, notwithstanding the failure of an impaired class to accept the plan under section 1129(a)(8),"[49] as long as all of the other criteria of section 1129(a) have been met. The cramdown may only be invoked with respect to each class of claims or interests that is impaired under and has not accepted the plan. Section 1124 sets forth the criteria for impairment of claims. Under section 1126(f), a class that is not impaired is conclusively presumed to have accepted the plan. Under section 1126(c), a class of claims accepts a plan if holders of at least two-thirds in amount and more than one-half in number have accepted the plan.

[49]124 Cong. Rec. H. 11,103 (Sept. 28, 1978); S. 17,420 (Oct. 6, 1978).

The cramdown in section 1129(b)(1) may only be requested by the proponent of the plan.[50] The proponent of the plan also has the burden of proof to demonstrate that the plan complies with the "fair and equitable" requirements in section 1129(b)(2)(A).[51] Usually, if a trustee has not been appointed, during the first 120 days after the date the order for relief is entered, only the debtor may file a plan and thus be able to invoke cramdown, in accordance with section 1121. After the 120 days have run, or 180 days to allow for solicitation of acceptances, and the debtor's exclusivity period is not extended, any party in interest that proposes a plan may request the use of the cramdown.

The court may not amend the plan, but rather must merely decide whether the plan is "fair and equitable" and complies with the requirements of sections 1129(a) and (b).[52] In the event that several plans satisfy these requirements, the court may only confirm one plan, in compliance with section 1129(c). The court has more power than at first may appear evident, for as the *Collier Bankruptcy Practice Guide* (CBPG) points out:

> as observed in the *Landmark*[53] case, once the Court has delineated the respect in which the fair and equitable test is not met, the effect is to suggest what plan would be acceptable and accordingly 'the plan could be readily modified.' Thus, the class of secured claims must be prepared for an attempt by the debtor, if it is feasible, to modify the plan to cure the deficiency.[54]

As section 1129(b)(1) specifies, the court must determine whether a plan discriminates unfairly, and is "fair and equitable" in respect to a dissident class or classes. Section 1129(b)(2)(A) sets forth criteria for determining whether a plan is "fair and equitable," but the court is offered no other guidance for determining whether a plan discriminates unfairly. The Congressional Record states that, "The requirement of the House bill that a plan not 'discriminate unfairly' with respect to a class is included for clarity."[55] Clarity about what? CBPG suggests that this requirement, "is essentially designed to provide equal treatment to classes of the same rank and character with a special view to multiple classes of unsecured claims including a class of unsecured subordinated claims."[56] Is this provision applicable to secured claims?

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[50] 124 CONG. REC. H. 11,104 (Sept. 28, 1978); S. 17,420 (Oct. 6, 1978); H.R. REP., *supra* note 25, at 414.

[51] 6 COLLIER BANKR. PRACTICE GUIDE, *supra* note 47, ¶91.07(3].

[52] H.R. REP., *supra* note 25, at 414.

[53] *In re* Landmark at Plaza Park, Ltd., 6 BANKR. CT. DEC. (CRR) 1312 (Bankr. D.N.J. 1980).

[54] 6 COLLIER BANKR. PRACTICE GUIDE, *supra* note 47, ¶91.07[3].

[55] 124 CONG. REC. H. 11,104 (Sept. 28, 1978); S. 17,420 (October 6, 1978).

[56] 6 COLLIER BANKR. PRACTICE GUIDE, *supra* note 47, ¶91.05, referring to H.R. REP., *supra* note 25, at 416–17.

> Although it might be argued that different treatment to a class of claims secured by real estate as contrasted, for example, with a class secured by equipment, constitutes unfair discrimination, it does not appear that this is the evil which the unfair discrimination provision was designed to prevent. These two classes would not be considered of the same character, and the different nature of the collateral should be sufficient to justify any rational distinction in treatment.[57]

In other words, the discrimination will rarely, if ever, be applicable to classes of secured creditors, because they do not fall on the priority ladder as classes of unsecured claims do. Countryman offers a contrary view, however, and argues that after section 506(a) is applied, all secured claims should be treated the same to the extent that they are properly secured.

The 1984 Amendments to the Code remedied some of the confusion resulting from the interplay of certain sections of the Code with the cramdown provisions. For instance, prior to the 1984 Amendments, the interaction of sections 1124 and 1126 with section 1129(b), as Coogan points out, might well have caused difficulties for certain classes of secured claims. He asks, "Can a plan proponent who has persuaded a majority of each class, except one, force that class to take some treatment which it does not vote to accept and still operate under section 1129(a)(8) rather than under the cramdown of section 1129(b)?"[58]

Recall that the cramdown may only be imposed on dissenting classes that are impaired under section 1124. Coogan realizes that a proponent of a plan might well have been aware of both the complexity and risks involved in a cramdown and might well have tried try to use the confirmation standards of section 1129(a)(8) by forcing a class of secured creditors (which is often composed of only one creditor) into one of the three subsections specified in section 1124 as a means of preventing that class from objecting.[59] Such a strategy by the debtor might only have worked because section 1126(f) held that an unimpaired class was "deemed to have accepted the plan."

For instance, consider the following situation: A debtor is in default and a secured creditor, the holder of the first mortgage, begins to foreclose. When the debtor files under chapter 11, foreclosure proceedings are stayed under section 362. The debtor proposes a plan of reorganization that will

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[57] 6 Collier Bankr. Practice Guide, *supra* note 47, ¶91.05.
[58] Coogan, *supra* note 1, at 351.
[59] *Id.* at 336.

cure all defaults including paying all interest and reinstating the first mortgage. The unsecured creditors accept the plan, as well as another secured creditor, the holder of a second mortgage who is impaired under the plan. The holder of the first mortgage rejects the plan since it believes that it would be better treated as a rejecting class under a section 1129(b)(2)(A) cramdown. The debtor argues that the plan complies with the requirements of section 1124, so that the holder of the first mortgage is no longer impaired under the plan. In response, the holder of the first mortgage argues that it is "impaired economically and legally in not being able to call in a low interest debt and reinvest at twice the old rate."[60] The holder of the first mortgage wants to accelerate the mortgage rather than having it reinstated, so it can pay off the holder of the second mortgage and take over the building for itself. The debtor, in turn, responds that the holder of the first mortgage is not impaired merely by losing the right to accelerate and call in the debt.

In this example prior to the 1984 Amendments the "deemed to accept" language of section 1126(f) directly conflicted with the actual rejection by the holder of the first mortgage. What result? As Coogan points out, in *In re Marston Enterprises, Inc.*,[61] the court claimed that the actual rejection controls and not the "deemed acceptance" of section 1126(f).[62] "The court read 'deemed' to mean basically the same as 'presumed,' " and held that such "a presumption can be rebutted by the actual facts."[63] Although other courts had followed *Marston*,[64] the legislative response in the 1984 Amendments overruled *Marston* and its followers. An unimpaired class no longer is "deemed to have accepted the plan." Rather, it is "conclusively presumed to have accepted the plan" and such presumption is not rebuttable by the actual facts. This new result is sensible because even prior to the 1984 Amendments in cases such as *Marston*, or our hypothetical, even though a class of secured creditors forced the debtor to seek the use of the cramdown, the court could have concluded that the plan was "fair and equitable" with respect to the class, realizing that the rejection of the plan by the secured creditors was most likely part of an attempt to renegotiate the original transaction, delay the reorganization, and compel the debtor to offer higher payments or better terms as part of settlement.

Another controversy involving the cramdown on secured creditors that was resolved by the 1984 Amendments is the relationship between section

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[60]*Id.* at 337–38.

[61]7 BANKR. CT. DEC. (CRR) 1403, discussed in *id.* at 339–40.

[62]Coogan, *supra* note 2, at 339–40.

[63]*Id.* at 340. *See* 7 BANKR. CT. DEC. (CRR) at 1407 where the court states, "the presumption of acceptance under § 1126(f) is *rebuttable* while the presumption of rejection under § 1126(g) is *conclusive*." (emphasis in original) and "To deem that a party has accepted a plan when the fact is that it has rejected the plan, is Alice in Wonderland reasoning which this court cannot accept."

[64]*See In re* Barrington Oaks General Partnership, 15 Bankr. 952 (D. Utah 1981); *In re* Spirited, Inc., 23 Bankr. 1004 (Bankr. E.D. Pa. 1982)

1129(b) and section 1129(a)(10). Prior to the 1984 Amendments section 1129(a)(10) held that for a plan to be confirmed, at least one class of claims had accepted the plan. There was some controversy about whether, to be confirmed, a plan had to be accepted by a voting class or whether the "deemed to accept" language of section 1126(f) sufficed.[65] As Broude points out:

> Assume a plan contains one class of secured creditors, two classes of unsecured creditors, and one class of interests. The unsecured classes and old equity are unimpaired but the secured class, which is impaired, votes against the plan. The question arises as to whether the provisions of section 1129(a)(10) have been satisfied in light of section 1126(f) . . . Has at least one class of claims accepted the plan, or is it necessary that there be a class of claims that actually has voted in favor of the plan?[66]

Some commentators such as Broude had persuasively argued that an actual accepting class should be required, "in light of the philosophy underlying chapter 11, which is to force a deal and to avoid cramdown."[67] He further argues that if no actual voting class is required and the debtor refuses to settle and prefers cramdown, then it is likely that the "plan will fall apart, resulting in a liquidation."[68] *Marston* also held that "one class of impaired claims must actively accept the plan."[69] Section 1129(a)(10) as amended by the 1984 Amendments now reads, "If a class of claims is impaired under the plan, at least one class of claims that is *impaired* under the plan has accepted the plan." (emphasis added) With the inclusion of the word "impaired" in section 1129(a)(10), the "conclusively presumed" acceptance of an unimpaired class under section 1126(f) will not suffice for purposes of section 1129(a)(10) and an actual accepting impaired class is required unless all classes are unimpaired. As amended, section 1129(a)(10) also facilitates negotiation and settlement.

C. SECTION 1129(b)(2)(A)

This subsection clarifies the meaning of the "fair and equitable" requirements in respect to secured claims. In particular, section 1129(b)(2)(A) sets out three alternatives for providing "fair and equitable" treatment to

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[65] 5 COLLIER ON BANKRUPTCY, *supra* note 6, ¶¶1129.03[4][d] and 1129.02[10]; Broude, *supra* note 1, at 450.

[66] Broude, *supra* note 1, at 450.

[67] *Id.*

[68] *Id.*

[69] 7 BANKR. CT. DEC. (CRR) at 1407–08.

classes of secured creditors under a cramdown. Before addressing these three alternatives, however, a few more general comments are necessary. First of all, as CBPG claims, section 1129(b)(2) states that the "fair and equitable" condition "includes the following requirements."[70] Section 102(3) states that "includes" is "not limiting." CBPG argues that "in theory other methods might satisfy the condition, although it is hard to conceive of an alternative provision in view of the fact that the third requirement, the 'indubitable equivalent' seems all encompassing."[71] As will be discussed later in this article, such an expansive reading of the "indubitable equivalent" standard in clause (iii) is rejected, especially in light of the legislative history of that clause at 124 Cong. Rec. H. 11,104 (Sept. 28, 1978); S. 17,421 (Oct. 6, 1978). At the other extreme is Coogan who reads section 1129(b)(2)(A) very restrictively and is troubled by the possibility of a case arising under a cramdown that is not covered by this section.[72] The weakness with Coogan's argument is that he fails to give enough weight to the Code definition of the word "includes." Given section 102(3), the three clauses in section 1129(b)(2)(A) are not meant to be all encompassing. Other criteria might well fulfill the "fair and equitable" requirements without necessarily fulfilling the "indubitable equivalent" standard. If the situation arises which troubles Coogan, a court could draw up an alternative "fair and equitable" requirement tailored to that particular situation.

The legislative history of this section does not resolve this confusion though it tends to support the view that the three clauses in section 1129(b)(2)(A) were not meant to be all inclusive. For instance, the Congressional Record states that:

> Although many of the factors interpreting 'fair and equitable' are specified in paragraph (2), others, which were explicated in the description of section 1129(b) in the House report were omitted from the House amendment to avoid statutory complexity and because they would undoubtedly be found by a court to be fundamental to 'fair and equitable' treatment of a dissenting class.[73]

The example included in the Congressional Record to support this claim is that, although not mentioned in section 1129(b)(2)(A), a "dissenting class should be assured that no senior class receives more than 100 percent of the

[70]6 COLLIER BANKR. PRACTICE GUIDE, *supra* note 47, ¶91.05.

[71]*Id.*

[72]Coogan, *supra* note 1, at 357ff.

[73]124 CONG. REC. H. 11,104 (Sept. 29, 1978); S. 17,420 (Oct. 6, 1978).

amount of its claims."[74] Such a factor would not fulfill the "indubitable equivalent" requirement standard, but would be a "fair and equitable" requirement.[75]

D. CLAUSE (i)

Clause (i)(I) permits cramdown if the dissenting class of secured creditors retains its liens securing its claims whether or not the debtor retains the collateral or transfers it to another entity. A secured creditor's liens secure the allowed secured claims to the amount as determined in section 506, unless the class takes the section 1111(b) election. Under section 506(a) a claim is secured to the value of the collateral. In the absence of the section 1111(b) election an undersecured claim is separated into two parts—a secured claim to the extent of the value of the collateral and an unsecured claim for the deficiency.

Each holder of such claims must be guaranteed an income stream of "deferred cash payments." Taken together, these "deferred cash payments" and lien retention requirements lead to the conclusion that, "The Code expressly provides that, in order to cramdown a plan on dissenting secured creditors, any new paper must be in the nature of an indebtedness, not an equity interest,"[76] and that this paper must be secured. Each holder must receive payments, as specified in the clause (i)(II):

(1)"totalling at least the allowed amount of such claim" and

(2)"of a value, as of the effective date of the plan," of an amount which is "at least the value" of the secured holder's interest in the collateral.

To put it simply, the total amount of the payments must equal at least the allowed amount of the claim and the present value of such payments must equal at least the value of the collateral.

The meaning of the phrase "allowed amount of such claim(s)" in clauses (i)(I) and (II) will depend on whether section 1111(b) is applicable to a class of dissenting secured creditors. The relationship between sections 1129(b) and 1111(b), which is one of the most complex and important of all of the issues affecting the cramdown, lies outside the scope of this article. Never-

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[74] *Id.*, which states that the deletion of this requirement "is intended to be one of style and not one of substance."

[75] *See* 5 COLLIER ON BANKRUPTCY, *supra* note 6, ¶1129.03[4][a]. It suggests that a plan that satisfies the requirements set forth in section 1129(b)(2)(A) may or may not be "fair and equitable" since other "fair and equitable" requirements outside section 1129(b)(2)(A) may not have been met.

[76] Blum, *Treatment of Interest on Debtor Obligations in Reorganization Under the Bankruptcy Code*, 50 U. CHI. L. REV. 430,445 (1983). Countryman rejects this view in favor of the position that stock may be issued under the "indubitable equivalent" standard.

theless, to understand how the cramdown works, it is important to appreciate at least the rudiments of the interaction between these two sections. Basically, section 1111(b) offers a secured creditor the option of having its claim secured to the full value of the claim, rather than secured to the value of the collateral and unsecured for the deficiency under section 506(a).[77] Although there are many reasons why a secured creditor would decide whether or not to use the section 1111(b) option, it is enough to know that a creditor will opt *not* to have the entire claim treated as secured if: "the present value of what is received on the secured claim plus the present value of the property it may be entitled to on the unsecured claim, is greater than the prospective payments it may receive if the full amount of the claim is treated as secured."[78]

E. CLAUSE (ii)

This clause holds that if the plan provides for the sale of any property of the estate subject to a secured creditor's liens that secure allowed secured claims, the creditor, in accordance with section 363(k), if he purchases such property, "may offset such claim[s] against the purchase price of such property." The Congressional Record for section 363 states that this provision:

> indicates that a secured creditor may bid in the full amount of the creditor's allowed claim, including the secured portion and any unsecured portion thereof in the event the creditor is undersecured, with respect to property that is subject to a lien that secures the allowed claim of the sale of the property.[79]

This interpretation assumes that section 363(k) entitles the secured creditor to bid. Before the 1984 Amendments were enacted, Countryman persuasively argued that as written, section 363(k) did not entitle secured creditors to bid. With the addition of the 1984 Amendments, however, secured creditors now definitely have the right to bid. In any case, in accordance with the Congressional Record, the section 1111(b) option is not available to secured creditors in respect to collateral that is being sold under section 363, since under section 363(k), the secured creditor is permitted to bid in the full amount of his allowed claims anyway.[80]

If the value of the collateral that is sold is less than the amount of the secured creditor's claims or if the creditor chooses not to offset his claims

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[77]124 CONG. REC. H. 11,104 (Sept. 28, 1978); S. 17,421 (Oct. 6, 1978).
[78]6 COLLIER BANKR. PRACTICE GUIDE, *supra* note 47, ¶91.06[2].
[79]124 CONG. REC. H. 11,093 (Sept. 28, 1978); S. 17,409 (Oct. 6, 1978).
[80]124 CONG. REC. H. 11,103-11,104 (Sept. 28, 1978); S. 17,420 (Oct. 6, 1978).

against the purchase price of the property, his liens will "attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii)" will be provided. Thus, if the liens do attach to the proceeds, the secured creditor will be protected by receiving either a cash stream under clause (i)(II) or the "indubitable equivalent" under clause (iii).

F. CLAUSE (iii)

A plan may also be confirmed notwithstanding the rejection of a class of secured creditors, if the plan provides for the realization of the "indubitable equivalent of such claims." This requirement of the "indubitable equivalent," which is also included in section 361(3) in regard to adequate protection, is taken from Learned Hand's opinion in *In re Murel Holding Corp.*[81] That case held that a secured creditor should not be deprived of his security interest "unless by a substitute of the most indubitable equivalence."[82]

Clause (iii)'s broad scope and generality may be either advantageous or disadvantageous depending on one's jurisprudential outlook—advantageous in that it offers a flexible "fair and equitable" standard and makes it more probable for the cramdown to work, or disadvantageous in that "its use in the adequate protection area is fraught with the dangers of ambiguity and imprecision."[83] The legislative history does not prove very helpful in defining the scope of the "indubitable equivalent" requirement. It does say that "abandonment of the collateral to the creditor would clearly satisfy indubitable equivalence, as would a lien on similar collateral" and points out that "unsecured notes as to the secured claim or equity securities of the debtor would not be the indubitable equivalent."[84]

In conjunction with clause (i)(I) this language in the legislative history would authorize secured notes as the "indubitable equivalent." As mentioned earlier, Countryman is troubled by the legislative history's rejection of equity securities as the "indubitable equivalent" and sees no valid reason for taking such a position. The arguments in favor of rejecting Countryman's position will be discussed later in this article in the section about enterprise valuation and the valuation of securities. To date, the issue has not been tested in court, most likely because it has yet to occur. Only rarely will a debtor attempt to compel a secured creditor to accept equity securities. In small chapter 11 or chapter 13 cases, usually involving only one or two secured creditors protected up to the value of their collateral, there will

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[81]75 F.2d 941 (2d Cir. 1935). *See* 124 CONG. REC. H 11, 104 (Sept. 28, 1978); S. 17,421 (Oct. 6, 1978).

[82]*Id.* at 942.

[83]6 COLLIER BANKR. PRACTICE GUIDE, *supra* note 47, ¶91.05[2].

[84]124 CONG. REC. H. 11,104 (Sept. 28, 1978); S. 17,421 (Oct. 6, 1978).

seldom be a need for the issuance of equity securities. And in large corporate reorganizations, involving hundreds or thousands of secured bondholders, the plan will most likely fail unless the debtor can convince the bondholders or their representative to agree to the plan and accept equity securities. As will be discussed later, the issue of whether secured creditors should have the final say about their acceptance of equity securities is closely tied to the issue of whether secured creditors should be granted extra negotiating leverage to protect their secured position.

The Congressional Record also states that "present cash payments less than the secured claim would not satisfy the 'indubitable equivalent' standard because the creditor is deprived of an opportunity to gain from a future increase in value of the collateral."[85] Given clause (i)(II), it is evident that cash payments less than the secured claim would not suffice, but the Congressional Record's explanation is troublesome. Recall that clause (i)(II) held that the present value of the payments is to be determined as of the effective date of the plan. Although the Congressional Record seems to be claiming that the secured creditor should share in the appreciation of the collateral, this may only be true up to the effective date of the plan, except in those cases in which the secured creditor makes the section 1111(b) election or other cases in which the plan is modified under section 1127(b). Section 1127(b) holds that modifications are limited to those instances in which the "circumstances warrant such modification" and in which modifications are proposed by either the proponent of a plan or the reorganized debtor. Since the debtor will almost never want to pay a secured creditor more money, in practice, a secured creditor's ability to modify a plan will be limited to the cases in which that secured creditor is the proponent of the plan. Therefore, unless the secured creditor makes the section 1111(b) option, he will most likely share in the appreciation of the collateral only up to the effective date of the plan. If he does elect the section 1111(b) option, even then he will not benefit fully from the increase in the value of the collateral, because the present value of his cash payments will have been determined as of the effective date of the plan and may only be changed if a modification is permitted.

The legislative history of "indubitable equivalence" is far from comprehensive though it does suggest that this standard is not all inclusive. The result is that the uncertainty over the proper application of the 'indubitable equivalent' requirement and the possibility of frequent disagreements over whether or not a substitution of collateral is "similar," "can easily lead to extended litigation which may have the effect of attempting to coerce a secured creditor into accepting less than its entitlement."[86] One issue which

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[85] *Id.*

[86] 6 Collier Bankr. Practice Guide, *supra* note 47, ¶91.05[2].

has been litigated is that a debtor cannot use the "indubitable equivalent" standard to bypass the requirements of section 1129(b)(2)(A)(i)(II).[87]

CBPG argues that if a secured creditor finds the debtor's proposal of "similar" collateral to be unacceptable, he should argue:

> (1) that the replacement collateral tendered as the indubitable equivalent is not, as a matter of law, the complete equivalent, because of various differences in the nature and quality of the two types of security; and
>
> (2) that the value of the proposed substitution is less than the original, and therefore does not satisfy the fair and equitable requirement.[88]

Consider these issues in relation to the following hypothetical which is drawn from the facts of *In re Mansfield Tire and Rubber Co.*:[89]

> A secured creditor objects to the confirmation plan offered by the debtor. He has cash collateral of $1,000,000 securing his debt. The debtor attempts to cramdown the plan under clause (iii) by claiming that a replacement lien on a vacant tire plant is the 'indubitable equivalent' for the cash collateral. What result?

In *Mansfield*, the court held that the replacement lien was adequate protection under section 361. Such a ruling might be justified under either the replacement lien test of section 361(2) or the "indubitable equivalent" test of section 361(3). But, as CBPG points out, in a cramdown, "the 'similar' collateral reference in the legislative history may preclude that type of outcome."[90] If so, the result will be that the "indubitable equivalent" phrases in sections 361(3) and 1129(b)(2)(A)(iii) will be interpreted differently.

Such a result is not as surprising as it may first appear, since section 361 includes a separate "replacement lien" authorization unlike section 1129(b)(2)(A) which does not. The legislative history of section 361 states that the "indubitable equivalent" standard in section 361(3) is to be used "if none of the other methods would accomplish the desired result."[91] Under this interpretation, a replacement lien on dissimilar collateral might be prohibited under the "indubitable equivalent" standard in both section 361(3) and section 1129(b)(2)(A)(iii) but for different reasons. The legislative history also includes within the scope of the "indubitable equivalent" standard of section 361(3) certain protection that is within the scope of section

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[87]*In re* Griffiths, 27 Bankr. 873 (Bankr. D.K.C. 1983).

[88]6 COLLIER BANKR. PRACTICE GUIDE, *supra* note 47, ¶91.05[2].

[89]Case No. 679-01239 (N.D. Ohio, November 26, 1979) (Williams, B.J.) cited in *id.*

[90]6 COLLIER BANKR. PRACTICE GUIDE, *supra* note 47, ¶91.05[2].

[91]H.R. REP., *supra* note 25, at 340.

1129(b)(2)(A)(ii) rather than within the scope of the "indubitable equivalent" standard of clause (iii).[92] This also leads to two different interpretations of the "indubitable equivalent" language. Finally, one might argue that section 361(3) could be used to authorize a replacement lien, independently of a "similar collateral" requirement. Under this interpretation a replacement lien could be authorized under section 361(3) but not under section 1129(b)(2)(A)(iii). Whether or not one accepts some or none of these arguments in favor of interpreting the "indubitable equivalent" standards in these sections differently, there is no denying that as the "indubitable equivalent" standard exists today, a *Mansfield* type situation under the cramdown would almost surely cause litigation.

G. SECURED CREDITOR'S ALTERNATIVES

The cramdown under section 1129(b)(2)(A) may only be invoked if a class of secured creditors chooses to reject a plan. Having worked through the "fair and equitable" requirements contained in the three clauses of section 1129(b)(2)(A), the question arises about what a class of secured creditors should consider in determining whether or not it should reject a proposed plan.[93] CBPG offers six factors for the secured creditor to consider when making such a decision:

(1) the extent of impairment of its claim;
(2) the value of the distribution proposed in the plan;
(3) the likelihood that forcing application of the fair and equitable provision of section 1129(b) will increase its ultimate return;
(4) the existence of other assets beyond the collateral and the extent to which it may reasonably be expected that the collateral will increase in value so as to base a decision upon making the section 1111(b) election;
(5) the risks involved in a valuation or fair and equitable hearing significantly delaying confirmation; and
(6) whether the debtor can sustain its burden of proof at such a hearing.[94]

There are no fixed rules for the secured creditor to follow. The individual circumstances of each case, including the specific nature of the collateral in question, will be important factors.[95] Many commentators believe,

[92] *Id.*, which specifies that "permitting a secured creditor to bid in his claim at the sale of the property and to offset the claim against the price bid in" is within the scope of section 361(3).

[93] 6 COLLIER BANKR. PRACTICE GUIDE, *supra* note 47, ¶91.07.

[94] *Id.*

[95] *Id.*

however, that the risks involved in valuation are often the most important.[96]

After rejecting a plan, a secured creditor might believe that it is not being given "fair and equitable" treatment under section 1129(b)(2)(A). If this happens, the secured creditor should reconsider the six factors listed above. In addition, it should at that time:

> (1) seek a determination of the secured status of its claim and the amount, if any, of its unsecured claim under section 506(a); and
>
> (2) to the extent that the class of secured claims contends that it is not being provided with the statutorily mandated fair and equitable treatment, . . . file objections to confirmation. . . . It is suggested that such an objection specify the nature of the alleged noncompliance with the requirements of section 1129(b)(2)(A).[97]

After rejecting a plan, the secured creditor next faces the many risks involved in valuation, to be discussed in part III.

PART III.

A. Valuation Under Section 1129(b)(2)(A)

As mentioned earlier in the discussion of the development of the pre-Code case law and legislative history, though the terminology about valuation for the purposes of reorganization often includes somewhat scientific and mathematical formulae, there is no avoiding the often heated environment that increases the potential of the importance of emotional, irrational factors in the decisions. "To paraphrase Justice Oliver Wendell Holmes, the participants may make their decision on intuitions deeper than logic."[98] Coogan aptly refers to the following words of Holmes, which though spoken in regard to a different issue, are quite applicable to accepting or rejecting a plan: "The action does not appear to have been arbitrary except in the sense in which many honest and sensible judgments are so. They express an intuition of experience which outruns analysis and sums up many unnamed and tangled impressions: impressions which may lie beneath consciousness without losing their worth."[99] Likewise, as Coogan also points out, in a recent reorganization case in California, the judge stated that "in a highly charged case, scarcely a single issue was settled on the basis of business

[96] *See* Broude, Coogan, Klee, and Pachulski, *supra* note 1.

[97] 6 Collier Bankr. Practice Guide, *supra* note 47, ¶91.02[3].

[98] Coogan, *supra* note 1, at 349.

[99] Chicago, Burlington & Quincy Ry. v. Babcock, 204 U.S. 585 (1907), cited in *id.*, n.179 at 349.

judgment."[100] The aim of this approach to the forum in which valuation occurs is to show:

> that it is wise to conduct negotiations aimed at producing a plan which will receive consent from the statutory majority of each class . . . Perhaps the principal use of section 1129(b) will be a bargaining club which dissidents on the one hand or the plan proponents on the other may employ to reach agreement rather than face the trials and tribulations of a section 1129(b) proceeding.[101]

For instance, one of the main incentives for avoiding a cramdown of a no-stock plan involves risks associated with enterprise valuation. Under the confirmation of a plan pursuant to section 1129(a), in which there is no "fair and equitable" requirement, a valuation of the business of the debtor is not contemplated.[102] In comparison, section 1129(b), with its "fair and equitable" requirements, requires such a valuation in many cases.[103] To avoid the highly charged environment that leads to a cramdown is therefore in all the parties' best interests.

The "fair and equitable" requirements are meant to entitle "each creditor to the equitable equivalent of his claim against the debtor."[104] Therefore, valuation is crucial. It "enters into fairness and equity because the measure of rights, under the fair and equitable standard, looks to collectibility as well as allowability."[105]

The method of valuation to be used depends on the purposes for the valuation. Under section 1129(b)(2)(A) there are three main types of valuation which are needed for different sections of the cramdown:

(1) Present value analysis and discount rate valuation.

(2) Enterprise valuation and the valuation of securities.

(3) Collateral valuation.

Types (1) and (3) will almost always be needed for a cramdown on secured creditors, unlike type (2) which is more frequently used in connection with a cramdown on unsecured creditors and equity holders. However, if Countryman is correct and secured creditors may be compelled to accept equity securities, then type (2) will also frequently be utilized in cramdowns on secured creditors. Also, for the purposes of determining the "feasibility" of a

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[100]Coogan, *supra* note 1, n.179 at 349, discussing *In re* Nite Lite Inns, 6 COLLIER BANKR. CAS. 2d (MB) 107, 110 (1982).

[101]Coogan, *supra* note 1, at 362.

[102]H.R. REP., *supra* note 25, at 414.

[103]*Id.*

[104]Bkr. L. Ed. § 42:85 (1979).

[105]Id.

plan, a type (2) enterprise valuation might be necessary for a cramdown on secured creditors.[106]

1. *Present value analysis and discount rate valuation*

Under section 1129(b)(2)(A)(i)(II), the court must make a present value analysis to determine the present value of deferred cash payments that each secured creditor must receive as part of his future cash stream. A discussion of this process for discounting future payments to present value lies beyond the scope of this article. However, in order to understand section 1129(b)(2)(A)(i)(II), it is first necessary to understand the rudiments of this process:

> What the Code does not define when it uses the term 'present value', and hence what the court may be required to determine, is the appropriate rate of interest which will serve as the standard by which the court must compare the difference, if any, between the current (present) value of deferred cash payments and the value of the collateral, under the terms of the proposed cramdown provision.
>
> What is the appropriate discount rate? It is suggested that such rate is equivalent to the rate of interest that would be paid on a similar obligation by the debtor considering a market rate of interest that reflects current supply and demand of money, the nature of the lender, the duration of the loan, the market's perception of the risk under the circumstances, and the nature of the collateral.[107]

There is often much disagreement between the parties about setting the discount rate, with the debtor arguing for a lower rate and the creditor for a higher one.[108] One of the results of this disagreement is that the court often

[106]On the topic of feasibility, *see* Landmark at Plaza Park, 7 Bankr. 653, 659 (D. N.J. 1980), in which the court cites six criteria from 5 COLLIER ON BANKRUPTCY., *supra* note 6, ¶1129.02[11] for determining feasibility:

1. the adequacy of the capital structure;
2. the earning power of the business;
3. economic conditions;
4. the ability of management;
5. the probability of the continuation of the same management; and
6. any other related matters which determine the prospects of a sufficiently successful operation to enable performance of the provisions of the plan.

[107]6 COLLIER BANKR. PRACTICE GUIDE, *supra* note 47, ¶91.05[1].

[108]*See In re* Sullivan, 26 Bankr. 677 (W.D.N.Y. 1982), which held that when the prime interest rate is greater than 16%, a plan which proposes to pay interest on a fully secured claim at a rate of 9.5% is not "fair and equitable" under section 1129(b)(2)(A).

steps into the fray to exercise its discretion and picks the discount rate which it deems to be appropriate.

2. *Enterprise valuation and the valuation of securities*

Enterprise valuation is closely tied to the valuation of equity securities. Frequently, as part of a reorganization plan, the debtor issues equity securities in the reorganized company to unsecured creditors and equity holders. If secured creditors consent, they too may receive equity securities. In such reorganizations, a cramdown may still be needed under section 1129(b)(1)(B) in regard to classes of unsecured creditors or under section 1129(b)(2)(C) in regard to equity interests because:

(1) If a cram down is used against a class of claims or interests, the court may have to determine whether securities issued under the plan have a value equal to the amount of the claims of the non-assenting class of creditors or the value of the interests of the non-assenting class of equity interests.
(2) In the alternative, if the proponent of a plan attempts to cram down a class of claims or interests by terminating the rights of the class or classes junior to the dissenting class, the court will have to value the securities issued under the plan in order to determine that no class senior to the dissenting class will receive more than full payment under the plan.[109]

Are similar valuations of equity securities and the concomitant valuation of the enterprise necessary if a cramdown is used against a class of secured creditors? Countryman's position to the contrary, the answer is, "No," because the author believes secured creditors cannot be compelled to accept equity securities. Unlike secured notes which protect the secured creditor's secured position, equity securities expose secured creditors to risks the drafters of the Code did not intend secured creditors to bear without so choosing. That secured creditors were to be treated differently than other creditors is explicit in light of the legislative history that claims that "[u]nsecured notes as to the secured claim or equity securities of the debtor would not be the indubitable equivalent,"[110] and therefore may only be ac-

[109] 5 COLLIER ON BANKR., *supra* note 6, ¶1129.03[4][f].

[110] 124 CONG. REC. H. 11,104 (Sept. 28, 1978); S. 17,421 (Oct. 6, 1978); Pachulski, *supra* note 1, at 949-50; Blum, *supra* note 76, at 445, agree. *See In re* N.E. Parks Lumber Co., Inc., 19 Bankr. 285 (1982), in which the court recognized the special status of secured creditors and issued income bonds rather than equity securities to better preserve the secured position of the secured creditor to the extent possible. However, though the court did not directly address the issue, its opinion seems to support Countryman's contention that a court may compel secured creditors to accept equity securities. Countryman is troubled

cepted by secured creditors if they so choose.

Isaac Pachulski demonstrates that the prohibition on compelling secured creditors to accept equity securities is further supported by comparing the secured creditor cramdown sections, on the one hand, with the unsecured creditor and equity holder cramdown sections on the other.[111] Section 1129(b)(2)(B)(i), in respect to unsecured claims, states that: "each holder of a claim of such class receive or retain on account of such claim *property* of a value, as of the effective date of the plan, equal to the allowed amount of such claim." (emphasis added) Section 1129(b)(2)(C)(i), in respect to equity interests, similarly provides that each holder receive or retain "property." The legislative history defined property as including "both tangible and intangible property, such as a security of the debtor or a successor to the debtor under a reorganization plan."[112] An earlier draft of section 1129(b)(2)(A) discussed in the legislative history provided that in respect to secured interests, each holder receive "property."[113] However, in stark contrast to this earlier draft of section 1129(b)(2)(A), which would have permitted the compelled acceptance of equity securities, and to the present sections 1129(b)(2)(B) and (C), which do permit the compelled acceptance of equity securities, present section 1129(b)(2)(A)(i)(II), in respect to secured claims, does not. Rather this section provides that each holder receive "deferred cash payments." The alternative under 1129(b)(2)(A)(iii) is that a secured creditor may receive the "indubitable equivalent" but, as mentioned earlier, the legislative history of this clause argues against compelling the acceptance of equity securities.[114] The same result is reached under clause (ii) which requires treatment in accordance with either clause (i) or (iii).

Sections 1129(b)(2)(B) and (C) deserve some clarification. They do not state that unsecured creditors or equity interests must be paid in property, but rather *if* they are to be paid, are to be paid in property. If, in a cramdown on secured creditors, secured debt exceeds the value of the enterprise, secured creditors will get paid in full before unsecured creditors or

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by reading clause (iii) as prohibiting the compelling of a secured creditor to accept equity securities, because such a prohibition would make the cramdown of a *Case* all-stock deal impossible and because the issuance of equity securities eases the financial burdens on the debtor and thereby increases the potential for feasibility. The author is not as troubled by these results. In effect, the Code prohibition on compelling a secured creditor to accept equity securities increases the bargaining position of secured creditors. Thus, the *Case* all-stock deal will most likely be confirmed, but only after the secured creditors negotiate a "step-up" as compensation for their increased risk. *See* H.R. Rep., *supra* note 25, at 414. Also, the fact that the issuance of equity securities will improve the financial condition of the debtor will serve as an incentive to secured creditors to accept equity securities. Therefore the results that trouble Countryman will rarely, if ever, come about.

[111]Pachulski, *supra* note 1, at 949–50.

[112]H.R. Rep., *supra* note 25, at 413.

[113]*Id.*

[114]See *supra* note 84.

shareholders will receive anything. Likewise, if unsecured and secured debt exceeds the value of the enterprise, the shareholders will receive nothing:

> Thus, a class of shareholders whose equity interests are eliminated may not prevent senior creditors from giving up value to an intermediate class of junior unsecured creditors as long as no class is provided for more than in full. However, in order to determine whether junior creditors are provided for more than in full, it will be necessary to value the consideration received under the plan. If the consideration received is stock of the debtor, then the business will need to be valued.[115]

Notice the competing negotiating threats at work here—the secured and unsecured creditors can threaten to give the shareholders nothing while the shareholders can complain that unsecured creditors are receiving more than payment in full and threaten to seek a valuation of the debtor:

> The threat of valuation gives negotiating leverage to the class of ownership interests. Since a valuation of the business must be made if the shareholders dissent, often seniors will give up value to shareholders to obtain their consent to the plan. If the shareholders consent a costly valuation may be avoided.[116]

In this example, enterprise valuation may be used by the shareholders as a weapon to convince the secured and unsecured creditors to avoid invoking the cramdown. In other instances, if the unsecured creditors receive nothing they might claim that the secured creditors were provided for more than in full, and similarly seek an enterprise valuation.

A few words are also in order to explain the repercussions on the then necessary enterprise valuation and the valuation of securities if Countryman's view is accepted and secured creditors may be compelled to accept equity securities under section 1129(b)(2)(A)(iii). First of all, full compensation for secured claims might well include a "step-up" as compensation:

> for their loss of priority and the increased risk that they are subjected to by that loss of priority. The legislative history suggests that compensation for this loss of priority should be provided by assigning a lower value to the securities given to the senior creditors than to the comparable

[115]Klee, *supra* note 1, at 144–145.

[116]*Id.*; Brudney and Chirelstein, *supra* note 33, at 125, agree. They write that seniors will make concessions to juniors, if the juniors forego "their nuisance power to delay the reorganization."

> securities given to junior creditors who have not lost a priority position . . . .
>
> The legislative history suggests that Congress saw no inconsistency between the requirement that no class receive more than 100 percent of its claims and the requirement that senior classes be compensated for a loss of priority. Perhaps one way to resolve any inconsistency is to recognize that the components of a claim include not only the amount of the claim, but also the quality of the claim, reflected in its priority, and the corresponding effect on the likelihood of repayment.[117]

A second issue involves the valuing of the securities to be issued. This valuation, as mentioned earlier, is closely linked to the reorganization or enterprise valuation.[118] As under Chapter X, the value of the securities:

> would be the difference between the reorganization value of the enterprise as a whole and the indebtedness with which the reorganized company would emerge under the plan. For example, if the value of the debtor on a 'going concern' basis was found to be $11 million and the plan provided for the debtor to emerge with indebtedness of $6 million, the equity securities to be issued under the plan would be valued at $5 million.[119]

This is the value to be used even if the market value of the securities is different from the reorganization value computed in the above formula because, "it [is] deemed appropriate to use the 'investment' value or 'intrinsic' value of the securities, based on a 'going concern' valuation, rather than 'spot market value' as the basis for valuation."[120] On both of these issues agreement is not unanimous and arguments have been made suggesting alternatives to step-up compensation and supporting market valuation.[121]

Just because a cramdown of secured claims may not necessitate a valuation of securities does not mean that it will also not necessitate an enterprise valuation. Recall that *DuBois* held that an enterprise valuation is necessary for determining questions of feasibility. In respect to secured claims, the feasibility issues will be in respect to the cash stream under sec-

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[117]Pachulski, *supra* note 1, at 945. See H.R. REP., *supra* note 25, at 414. Countryman wants the proponent of the plan to have negotiating leverage in the form of the step-up, while the author believes such a negotiating weapon belongs in the hands of the secured creditors.

[118]*Id.* at 941–42.

[119]*Id.* at 942.

[120]*Id.*

[121]*See* Brudney and Chirelstein, *supra* note 33, at 136–41; Pachulski, *supra* note 1, n.96, at 945–46.

tion 1129(b)(2)(A)(i)(II). A few words about enterprise valuation are therefore in order.

The procedure for valuing the enterprise harks back to the formula used in *DuBois*, because as Pachulski states:

> Congress was aware of the test applied under Chapter X and did not suggest that a different standard would be used in applying the fair and equitable test under Chapter 11. In fact, it was stated that the application of the rule would require 'a full valuation of the debtor as the absolute priority rule does under current law.'[122]

As mentioned earlier, the *DuBois* formula involves: "Projecting the enterprise's income stream and then determining a discounted present value for that income stream by multiplying the average annual projected income by a multiplier based on an appropriate capitalization rate."[123] This two-step process involves making separate valuations for the income stream and for the discount rate. In regard to the latter:

> This discounting is accomplished by multiplying the average annual projected earnings by a multiplier that is the inverse of the capitalization rate. For example, if the capitalization rate (that is, the expected rate of return) were 20 percent, the multiplier would be 5, if the capitalization rate were 10 percent, the multiplier would be 10. Thus, the higher the expected rate of return required by investors, the lower the multiplier and thus the lower the going concern value of the debtor.[124]

As Pachulski points out, this procedure is not cast in stone, and the going enterprise valuation procedure is not necessarily the best method for calculating the value of all parts of the enterprise.[125] He offers some examples:

> [N]onproductive assets, such as excess working capital or cash, excess or abandoned plants, other nonproductive real or personal property held for liquidation, and generally any assets not necessary to produce the anticipated income stream, would be valued separately and their value added to the going concern value in determining reorganization value.[126]

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[122] Pachulski, *supra* note 1, n.149 at 963, citing H.R. Rep., *supra* note 25, at 223-24.

[123] Pachulski, *supra* note 1, at 940.

[124] *Id.*

[125] *Id.* at 941.

[126] *Id.*

If additional working capital was needed to enable the reorganized debtor "to achieve the projected income stream, that amount [would be] deducted from reorganization value."[127] And finally, if the liquidation value happened to be higher than the going concern value, then the liquidation value would be used, because then there would be a liquidation plan.[128]

It is also important to realize that even if the feasibility issue does not arise in respect to the cash stream for secured claims, as mentioned earlier, an enterprise valuation will be necessary independently of the secured creditors, if equity securities are issued to unsecured creditors or equity interest holders.

3. *Valuation of collateral*

The valuation of collateral is one of the most important issues involved in the cramdown on secured creditors. Keep in mind that section 506(a) holds that value, "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any bearing on such disposition or use on a plan affecting such creditor's interest."

It should be self-evident that serious disagreements about the valuation of collateral will usually arise in situations in which a secured creditor is undersecured for, under section 1129(b)(2)(A)(i)(II), the present value of the cash stream must be at least equal to the value of the collateral, and not to the value of the claim. In such a situation, another way for the secured creditor to get more money, other than by seeking a higher valuation of the collateral, is to seek an adjustment in the discount rate.

During a reorganization, collateral may be valued at different times for different purposes, *e.g.*, a section 362(d) valuation for determining adequate protection, a section 1129(a)(7) best interest of creditor's test to protect dissident members within a class, and a section 1129(b) collateral valuation to protect dissenting secured classes. These different valuations within any one reorganization raise important ethical issues for the attorneys who represent the debtor or secured creditors. For instance, during the early stages of a reorganization, a secured creditor might try to vacate the section 362(d)(2) automatic stay on enforcement of liens against property of the debtor by arguing under that section that, "The debtor does not have any equity in such property. My claim is worth $100,000, while the value of the collateral is only $50,000."[129] For the purpose of escaping from the stay, it is in the secured creditor's best interest to argue for as low a value as possible

[127] *Id.*

[128] *Id.*

[129] 3 COLLIER ON BANKR. PRACTICE GUIDE, *supra* note 47, ¶52.05.

for the collateral. The debtor, on the other hand, will seek to argue for as high a value as possible.

At the time of a collateral valuation for the purpose of a best interest of creditor's test under section 1129(a)(7), the tables will turn—the secured creditor will argue for a higher liquidation value and the debtor for a lower one. For the purpose of collateral valuation under a cramdown on secured creditors, the secured creditor will argue for an even higher value, because the greater the value of the collateral, the higher will be the present value of the cash stream or value of the "indubitable equivalent."

Unless a wild fluctuation in the value of the collateral has occurred "(such as might occur with respect to securities, seasonal inventory, commodities, etc.) or unless a different *standard* of valuation is applicable, the secured creditor might find itself taking truly inconsistent positions notwithstanding the legislative intent." (emphasis in original)[130] Other situations that would justify submitting in good faith different valuations of collateral include cases in which at first there are dim prospects of reorganization (which would justify a secured creditor arguing in favor of liquidation value for section 362 purposes) but later there are high hopes for a plan being confirmed (which would justify a secured creditor arguing in favor of a high going concern value for "fair and equitable" purposes). In the absence of one of these applicable excuses, however, the submission of different valuations of collateral should be seriously questioned by the court.

It must also be remembered that the court will often step in to assist with valuation. As CBPG demonstrates, although the issue of collateral valuation is one best suited to a case by case approach, "with due consideration given to the facts and interests involved at the particular time," there is a tendency for the courts to use "the standards of commercial reasonableness adopted from the Uniform Commercial Code."[131] It points out that the courts are moving in the direction in which: "only in the rarest of circumstances where other methods of disposition are precluded, should the property be valued at forced sale standards; generally, value of collateral should be determined by what could be obtained from the most commercially reasonable disposition under the circumstances."[132]

For purposes of a cramdown, in the case of income-producing collateral, Pachulski offers a few arguments in favor of "going concern value" (which he views as the most commercially reasonable) over liquidation value:

> (1) The 'fair and equitable' test would appear to add little to section 1129(a)(7) if the collateral were valued on

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[130] *Id.* (emphasis in original).
[131] *Id.*
[132] *Id.*

the basis of liquidation value when applying the 'fair and equitable' test.

(2) . . . It would appear to be inconsistent with th[e] judgment [that junior classes should not participate in going concern value when senior classes are not being paid in full] to limit the inadequately collaterized secured creditor to a distribution based on the liquidation value of the collateral with the result that junior classes would be permitted to share in the going concern value of the collateral, even though the secured creditor was not receiving the full amount of its claim.

(3) . . . There is authority under the old Bankruptcy Act that suggests that, when the debtor is attempting to 'cram down' a secured creditor whose collateral consists of an income-producing asset by paying the creditor the value of its interests in the collateral, the collateral should be valued on a 'going concern' basis.[133]

Some collateral "is not, of itself, income-producing, but may have greater value as part of a going concern rather than [in] liquidation."[134] Such collateral, like inventory and accounts receivable, requires slightly different treatment. Here, Pachulski supports going concern value for accounts receivable of that "face value, subject to an appropriate bad debt reserve" and cost of collection; and for inventory, "that price that would be obtained from customers in the ordinary course of business."[135] For non-income producing collateral, such as machinery or real estate, which "unlike inventory and acounts, may not be sold or realized upon in the near future as part of the debtor's business operations," he suggests that the standard of valuation should be the fair market value less costs incurred in selling the property.[136]

It must also be kept in mind that even in cases where the parties agree on the method of valuation to be used, they might strongly disagree about the actual results that the agreed upon method produces. In *In re Rodgers Development Corp.*[137] for instance the expert appraiser of the debtor determined the fair market value of a piece of property to be $801,000 and the ex-

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[133]Pachulski, *supra* note 1, at 958–60, though he does cite some authority, including *In re* Jumpers Equities, Ltd., 4 BANKR. CT. DEC. (CRR) 1269 (D. Md. 1978), at 960, for the view that the dissenting secured creditor need not receive the full going concern valve, but rather that the " 'going concern bonus' must be allocated on the basis of an 'equitable apportionment' among all the parties." 4 BANKR. CT. DEC. (CRR) at 1270.

[134]Pachulski, *supra* note 1, at 961.

[135]*Id.* at 961–62.

[136]*Id.* at 962.

[137]2 Bankr. 679 (Bankr. E.D. Va. 1980).

pert appraiser of the secured creditor determined it to be $704,000 (for the purposes of determining adequate protection under section 362(d)(2)). Both appraisers used accepted real estate fair market valuations—the court rejected both figures in favor of a "reasonable" value of $750,000.

Finally, the secured creditor faces yet another risk in the valuation of collateral. Notice that the subsections of section 1129(b)(2) refer to "claim(s)" and not to "creditor(s)." As previously mentioned, in accordance with section 506(a), a secured claim is secured only to the value of the collateral and is unsecured for the deficiency. Only the secured claim may be crammed down under section 1129(b)(2)(A), while the deficiency (if it exists) may only be crammed down under section 1129(b)(2)(B). Therefore, if a valuation of collateral for the purposes of a cramdown on secured creditors demonstrates that a secured creditor's claim is not completely secured, that creditor will face the same risks and problems that other unsecured creditors face.

B. Conclusion

The risks and uncertainties involved in a cramdown on secured creditors are great. First, the cramdown provisions themselves cause much confusion. For instance, conflicting interpretations of the "indubitable equivalent" standard will lead to much litigation to determine what is "similar" collateral and whether or not a court may compel secured creditors to accept equity securities. Second, more ambiguity arises from the interaction between the cramdown provisions and other related Code provisions. Third, collateral valuation and the setting of a discount rate are inherently risky to both the debtor and the secured creditors. Disagreement may arise over the proper standards for valuing collateral or the method for determining the discount rate. Or, even if the debtor and secured creditors use the same standards or methods, they nevertheless may generate different results. These disputes in turn will expose the parties to the uncertainties involved in the judicial determination of collateral valuation or the discount rate. Fourth, if an enterprise valuation and valuation of securities are necessary, greater uncertainties and complex valuation issues arise. Fifth, a cramdown may cause delays that will make confirmation of a plan difficult, if not impossible. Sixth, in large, complicated corporate reorganizations, the imposition of a cramdown is more likely to lead to the liquidation of the debtor than to the confirmation of a plan. Lastly, a cramdown will most likely cause parties to become more intransigent and lead to protracted litigation and adversity.

All of these risks and uncertainties may be avoided if the parties avert a cramdown. "The imposition of the fair and equitable standard and a modified version of the absolute priority rule in [C]hapter 11 is thus designed to bring the parties to the bargaining table in an attempt to avoid the various risks,"[138] and uncertainties described throughout this article. The threat of a cramdown thus becomes an important factor encouraging settlement. Granted, under certain circumstances, it might be to a party's advantage to cramdown a plan, but in most chapter 11 cases, it will be in the best interest of all the parties to reach a settlement and to consent to a plan under section 1129(a), rather than to resort to a cramdown under section 1129(b).

ADDENDUM

The risks involved in the valuations needed under a cramdown and the workings of the cramdown provisions themselves can all be better understood by looking at a few problems. The following fact situation and problems are partly borrowed and partly based on facts and problems of Kenneth N. Klee.[139]

FACTS

Assume that a creditor in 1978 loaned debtor $1,000,000, secured by a mortgage on a parcel of real estate worth $1,050,000. The debtor is a real estate developing company and this parcel of real estate is one of its prime holdings. Over the next year, the real estate market in that part of the country collapses, forcing the debtor to seek protection from his creditors. On November 1, 1979, the debtor files for reorganization under chapter 11. Prospects for a successful reorganization look bleak and the secured creditor seeks a valuation under section 362(d)(2) in an attempt to gain relief from the automatic stay. In determining the value of the property, the court upholds a liquidation value of $400,000, which is equal to the going concern value in this depressed real estate market.

The prospects for a reorganization begin to pick up when three Fortune 500 companies decide to build their corporate headquarters on land owned by the debtor. The debtor proposes a plan of reorganization, effective as of January 1, 1980. Time is of the essence since the three Fortune 500 companies will look elsewhere if the debtor does not make a deal within one month. "[T]he plan proposes to pay the secured creditor a total of $600,000, without interest, in four equal installments of $150,000, commencing one year after the effective date of the plan. The mortgage will remain on the

[138] Broude, *supra* note 1, at 454.
[139] Klee, *supra* note 1, at 156ff.

real estate to secure those payments."[140] The secured creditor, in a class by himself, since he is the only holder of a mortgage on that particular parcel of real estate, opposes the plan. The debtor invokes the cramdown under section 1129(b)(2)(A) and asserts that the court should confirm the plan, notwithstanding the dissent of the secured class, because under the plan that class will receive "fair and equitable" treatment. Is that plan "fair and equitable" with respect to the secured creditor?

First of all, for the purposes of the cramdown, the collateral must be revalued. Given that the fair market value of the real estate has substantially increased in value and that this parcel is an integral part of any reorganization plan, the going concern fair market value should be used. As of the effective date of the plan, the court finds the collateral to be worth $600,000.

CLAUSE (i)—PROBLEM 1

Clause (i)(I) is fulfilled since the mortgage will continue on the parcel of real estate for $600,000 unless the secured creditor takes the section 1111(b) election. Clause (i)(II) requires that the total amount of cash payments must at least equal the allowed amount of the claim. The secured creditor's secured claim equals $600,000 and the plan provides for it to receive four equal payments of $150,000. Since these four payments total $600,000, this condition has been met.

But does the present value of the payments equal the value of the collateral? The answer is, "No," because "since no interest is to be paid, the present value of the four payments will be less than the $600,000 [the value of the collateral] and the present-value test is not met."[141]

For the debtor to meet the "fair and equitable" standard for present value, and make four equal payments, the following chart of interest rates and payment amounts that all have present values of $600,000 proves helpful:

Interest Rate	*Amount of Each Payment*
10%	$189,282
12%	$197,541
13%	$201,717
14%	$205,923
16%	$214,425
18%	$223,043

[140] *Id.* at 156.
[141] *Id.* at 157.

20%	$231,773
22%	$240,612
24%	$249,555
26%	$258,600
28%	$267,741
30%	$276,900

Notice that the interest (discount) rate chosen by the court greatly affects the size of the annual payments that must be made. All of the above interest rates and related payments would fulfill the present-value test and might be chosen by the court as satisfactory.

SECTION 1111(b) OPTION—PROBLEM 2

If the secured creditor opted for application of section 1111(b), his secured claim would be for $1,000,000 (the value of the debt) rather than $600,000 (the value of the collateral). "Assume that the [debtor] proposes to pay the secured creditor a total of $1,000,000, without interest, in four equal annual installments of $250,000, commencing one year after the effective date of the plan, secured by the mortgage on real estate."[142] As in the previous example, the requirement in clause (i)(I) would be fulfilled as well as to the total principal-amount requirement in clause (i)(II). Here too, the question is whether the present value of the payments equals the value of the collateral, which is $600,000. The answer depends on the discount rate chosen by the court. If the court chooses a rate of 25%, then the present value of the payments is only $590,500 and confirmation will fail. If, however, the court chooses a rate of 20%, the present value of the payments will be $647,250, the "fair and equitable" standards will be met, and the plan will be confirmed.[143] Notice that the difference between confirming and not confirming a plan may be only a matter of a few percentage points in the chosen interest rate. Also notice that if the 20% rate is chosen, "if the class of equity ownership interests were to dissent, the plan would not be confirmed as the secured creditor would receive more than payment in full,"[144] since the present value of the payments is greater than the value of the collateral.

CLAUSE (ii)—PROBLEM 3

Assume that the plan proposes for the debtor to sell the parcel of real estate for $600,000, free and clear of the secured creditor's mortgage, with the mortgage attaching to the proceeds of the sale. Also assume that the

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[142] *Id.* at 158.
[143] *Id.*
[144] *Id.* at 159.

debtor proposes the same plan as that offered in problem 1, of four equal payments of $150,000. Under section 363(k), in accordance with the legislative history of the Code and the 1984 Amendments, the secured creditor will be entitled to bid both the secured and unsecured parts of his claim and offset his entire claim against the purchase price. The secured creditor would not be able to make the section 1111(b) option.

If the secured creditor either chooses not to offset his claims against the purchase price, or rejects the plan, the sale would not change the result reached in problem 1, and therefore the treatment would not comply with the "fair and equitable" requirements and the plan would not be confirmed.

CLAUSE (iii)—PROBLEM 4

Suppose the debtor proposes to offer the secured creditor a replacement lien on another prime piece of real estate with a market value of $600,000? This would most likely satisfy the "indubitable equivalent" "similar" collateral requirements. What about a replacement lien on a parcel of real estate with a market value of $400,000? This would probably fail to meet the "similar" requirement. What about a replacment lien on the debtor's office building? This would probably not satisfy the "similar" requirement. What about unsecured notes in the reorganized company? These too would fail to fulfill the "indubitable equivalent" requirement. What about secured notes? These would satisfy the "indubitable equivalent" standard. Finally, what about equity securities? The arguments go both ways, though the author believes they would fail to fulfill the "indubitable equivalent" standard. Under all of these secenarios, given the ambiguity in the "indubitable equivalent" requirement, litigation would probably be needed to determine the result.